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Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LEBOEUF, LAMB & LEIBY,

Petitioners,

—against—

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, Debtor,

Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

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IN THE

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RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LEBOEUF, LAMB & LEIBY, *Petitioners,* *—against—* CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, Debtor, *Respondent.*	No. 890

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

Opinions Below

The opinion (by District Judge Chesnut) of the Court of Appeals for the Fourth Circuit (before Chief Judge Parker, Circuit Judge Soper and District Judge Chesnut) is reported at 240 F. 2d 546 (1957). It is also printed in the Appendix to Petitioners' brief, at page 38.

The opinion of the United States District Court for the Eastern District of Virginia (the Reorganization Judge)

is not reported. It is printed at page 3 of the Appendix to Petitioners' (Appellants') brief in the Court of Appeals below and in the Appendix to the brief of the Securities and Exchange Commission in this Court.

Jurisdiction

The judgment of the Court of Appeals was entered on January 7, 1957. The petition for a writ of certiorari was filed on April 8, 1957. The jurisdiction of this Court is invoked under 28 U. S. Code, § 1254 (1).

Question Presented

Is a federal judge, administering the estate of a Virginia Corporation in the United States District Court for the Eastern District of Virginia under Chapter X of the Bankruptcy Act, in passing on an application by former directors of the Debtor for fees and expenses incurred by them in defeating, on the ground of statute of limitations, an action for breach of fiduciary duty brought against them by the Reorganization Trustees of the Debtor in the United States District Court for the Southern District of New York, *required* to apply a New York statute governing reimbursement of litigation expenses?

Statement of Case

Petitioners were attorneys for and are the assignees of two individuals, Fogarty and Freeman, who were sued, among others, in a plenary action brought by respondent (and his co-Trustee, now deceased) as Reorganization Trustees of the Debtor in the United States District Court for the Southern District of New York. Central States Electric Corporation, a Virginia corporation, is the Debtor

in a reorganization proceeding under Chapter X of the Bankruptcy Act in the Eastern District of Virginia. The Debtor was an investment company, whose assets in 1929 were worth about $400,000,000. In February 1942 their worth had shrunk to about $1,300,000, causing the Debtor to file a petition for reorganization under Chapter X.

The present Trustee and Robert G. Butcher were appointed Trustees in 1944-1945, and after making an investigation as directed by the Court of Appeals for the Fourth Circuit (*Committee for Holders, etc.* v. *Kent,* 143 F. 2d 684 (1944)) and obtaining authorization from the Reorganization Judge, instituted a plenary action in the United States District Court for the Southern District of New York (hereinafter referred to as the "Trial Court"). There were many defendants, including Harrison Williams, the controlling stockholder. No diversity of citizenship of the parties was alleged. Jurisdiction was founded upon the provisions of Article I, Section 8, Clause 4, and Article III, Section 2, of the Constitution of the United States and the Bankruptcy Act, particularly Section 2(a) 7 (11 U. S. C. A. § 11(a)(7)). The defendants' opposition to the jurisdiction of the New York District Court over the action was sustained by the District Court (*Austrian, et al.* v. *Williams, et al.,* 67 F. Supp. 223 (1946)). The Court of Appeals for the Second Circuit reversed (159 F. 2d 67 (1946)) and this Court affirmed (*Williams, et al.* v. *Austrian, et al.,* 331 U. S. 642 (1947).)

The complaint alleged that the defendants, including Fogarty and Freeman, former directors of the Debtor, had over-reached the Debtor and looted it in a series of transactions. After protracted litigation, the Trial Court found, with respect to three causes of action, that Fogarty and Freeman, acting under the domination of Williams, had failed to exercise due care and prudence in discharge of

their responsibilities to Central States and had acted contrary to the interest of Central States, and that plaintiffs were entitled to recovery against them on these three transactions in the amount of $748,122.24 in respect of Fogarty and $593,693.44 in respect of Freeman. The Trial Court determined, however, that recovery against the defendants Fogarty and Freeman was barred by limitations (103 F. Supp. 64, at p. 117 (1952)) and entered a judgment dismissing the complaint against Fogarty and Freeman.*

Subsequently, Fogarty and Freeman applied to the Trial Court for allowance of their expenses including attorneys' fees incurred by them in the defense of the Trustees' action. This application was based on Section 64 of Article 6-A of the General Corporation Law of New York. The Trial Court, which had conducted the trial of the Trustees' action, acting under the erroneous impression that it was absolutely constrained by the New York statute to grant the application, allowed Fogarty and Freeman $30,000 for attorneys' fees and $1,185.53 for disbursements. It was not then brought to the Trial Court's attention that Petitioners had theretofore been paid $25,000 by Fogarty and Freeman "on account" of fees for services rendered to them by petitioners.**

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*A judgment was entered against Harrison Williams and another defendant which was subsequently reversed by the Court of Appeals for the Second Circuit on the ground of statute of limitations (*Austrian, et al.* v. *Williams, et al.*, 198 F. 2d 697 (2d Cir. 1952).) Petition for certiorari was denied by this Court (344 U. S. 909 (1952).) However, neither Fogarty or Freeman nor the Trustees of the Debtor appealed from the judgment against Fogarty and Freeman.

**Neither the Reorganization Judge nor the Court below dealt with the right of Petitioners to compensation under the New York statute on the assumption that the New York statute might be applicable. The Trial Court, under the erroneous impression, first, that it was constrained to apply the New York law and, second, that under New York law it was mandatory to grant an allowance, did so. Subsequent decisions established beyond question that the Trial Court was in error not only in believing that it was required to apply

The Trustees appealed to the Court of Appeals for the Second Circuit from the order of the Trial Court granting the allowance to Fogarty and Freeman. The Court of Appeals for the Second Circuit reversed the Trial Court's order, holding that the question of allowances to be paid in a reorganization proceeding was within the exclusive jurisdiction of the Reorganization Judge in charge of the Debtor's estate and that the Trial Court's order granting the allowances was an incursion upon the exclusive power of the Reorganization Judge. On reargument, the Court of Appeals expanded on the point, declaring that any allowance made would be payable by the Debtor, arose out of a lawsuit that had represented a contingent asset of the Debtor's estate, and that the allowance was connected with the plan and incident to the reorganization. As such and "being fixable after confirmation of the plan, they were 'subject to the approval of the [reorganization] judge'" (216 F. 2d 278 (1954).) A petition for a writ of certiorari was denied by this Court (*Fogarty, et al.* v. *Austrian, et al.*, No. 550, 348 U. S. 953 (1955)).

Thereafter, Fogarty and Freeman assigned their rights to such reimbursement to Petitioners, who applied to the Reorganization Court for allowances as assignees under Article 6-A of the New York General Corporation Law, and, alternatively, in their own right for allowances under Chapter X of the Bankruptcy Act.* After a hearing, the Reorganization Judge (Judge Hutcheson) dismissed the

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the New York law, but also that it had no discretion even under New York law to deny the application because of the wrongdoing of Fogarty and Freeman. *Austrian, et al.* v. *Williams, et al.*, 216 F. 2d 278 (1954); *Diamond* v. *Diamond*, 307 N. Y. 263 (1954). We believe that not only were Petitioners not entitled to any compensation under the Bankruptcy Law but were not entitled to compensation under the New York law because of the wrongdoing of their assignors.

*The claim of Petitioners to compensation on this latter alternative ground is not being urged before this Court.

petition, holding that Article 6-A of the New York General Corporation Law was not binding on the Reorganization Court, but, on the contrary, the rights of Petitioners to compensation must be determined in accordance with principles applicable under bankruptcy law without reference to state law. As to the alternative contention that Petitioners were entitled to compensation under the Bankruptcy Act, the Reorganization Judge held that the efforts of Petitioners on behalf of their clients to avoid liability for claims asserted against them by the Reorganization Trustees contributed nothing to the reorganization and that these services had not resulted in any benefit to the estate of the Debtor. The Reorganization Judge further pointed out that, while Fogarty and Freeman had escaped a money judgment for mismanagement of the affairs of the Debtor, it was only because of the statute of limitations.

Petitioners thereupon appealed to the United States Court of Appeals for the Fourth Circuit, which affirmed the order of the Reorganization Judge holding that the New York statute was not controlling on the Reorganization Judge; that the petition for allowances must be governed by the provisions of Chapter X of the Bankruptcy Act; that there was no basis under the Bankruptcy Act for an allowance to Petitioners because their assignors, Fogarty and Freeman, had acted adversely to the interests of the Debtor's estate, and that they had no interest either in opposition to or in the success of the reorganization plan. It should be noted also that the Court below stressed the fact that not only was there complete justification for the bringing of the action by the Trustees against Fogarty and Freeman, but that recovery against them failed "by reason only of the successful defense of limitations, as to a very large amount of damages awarded." (Pet. for Cert., App., p. 52.)

Argument

I.

THE DECISION OF THE COURT BELOW DOES NOT WARRANT FURTHER REVIEW BECAUSE IT IS CLEARLY CORRECT, RAISES NO NOVEL QUESTION, AND IS NOT CONTRARY TO OR IN CONFLICT WITH DECISIONS OF THIS COURT OR OTHER COURTS OF APPEAL.

Over a period of years, this Court has made it plain in a series of cases that the business of fixing allowances in a reorganization proceeding under Chapter X of the Bankruptcy Act is the peculiar province of the Reorganization Judge. In determining applications for allowances, the Reorganization Judge must, while exercising a sound discretion, look to and adhere to the provisions of the Bankruptcy Act and the standards set up by this Court regarding allowances. This Court has held that if the Bankruptcy Act is to be administered uniformly throughout the country, the judgment of the Reorganization Judge in fixing allowances must not be hampered—to say nothing of being controlled—by the requirements or provisions of a particular state law, whose provisions might or might not be different from those of the Bankruptcy Act, whose standards might or might not be different from those established by this Court. *Brown, et al.* v. *Gerdes, et al.*, 321 U. S. 178 (1944); *Leiman, et al.* v. *Guttman, et al.*, 336 U. S. 1 (1949); *Callaghan* v. *Reconstruction Finance Corporation*, 297 U. S. 464 (1936), *Vanston Committee* v. *Green*, 329 U. S. 156 (1946); *Pepper* v. *Litton*, 308 U. S. 295 (1939).

In *Vanston Committee* v. *Green, supra*, this Court said, at pages 162-163:

> "In determining what claims are allowable and how a debtor's assets shall be distributed, a bank-

> ruptcy court does not apply the law of the state where it sits. *Erie R. R.* v. *Tompkins,* 304 U. S. 64, has no such implication. That case decided that a federal district court acquiring jurisdiction because of diversity of citizenship should adjudicate controversies as if it were only another state court. See *Holmberg* v. *Armbrecht,* 327 U. S. 392. But bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles."

In *Pepper* v. *Litton, supra,* this Court held that a reorganization judge had power to disallow or subordinate a claim based on a judgment procured in a state court by an officer of the debtor in reorganization proceedings, because the officer was found guilty by the reorganization judge of improper conduct. This Court stated:

> "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections." (pp. 307-8)

This Court stated in *Brown* v. *Gerdes, supra,* at page 182, as follows:

> "In all cases persons who seek compensation for services or reimbursement for expenses are held to fiduciary standards. § 249; *Woods* v. *City National Bank Co.,* 312 U. S. 262, 267-269. And § 250 contains special appeal provisions governing orders granting or denying allowances. *Dickinson Industrial Site* v. *Cowan, supra.* Moreover a plan of reorganization must provide 'for the payment of all costs

and expenses of administration and other allowances which may be approved or made by the judge.' § 216(3). In addition the plan must provide, in furtherance of the purpose of the Act to protect the security holders against previous acts of mismanagement and to preserve all assets of the estate (S. Rep. No. 1916, 75th Cong., 3d Sess., p. 22; H. Rep. No. 1409, *supra,* pp. 42-44), for retention and enforcement by the trustee of all claims of the debtor or the estate not settled or adjusted in the plan. § 216(13). Finally, § 221(4) provides that in approving any plan the judge must be satisfied that 'all payments made or promised' by the debtor, the new company, or any other person, 'for services and for costs and expenses' are not only fully disclosed but 'are reasonable or, if to be fixed after confirmation of the plan, will be subject to the approval of the judge.' "

These decisions of this Court show that the decision of the Court below is neither novel nor in conflict with prior decisions of this Court. The decision of the Court below deals with the kind of problem that was dealt with in the decisions of this Court cited above. It deals with the character of persons entitled to compensation in a reorganization proceeding, the circumstances under which compensation is allowed, the standards applicable, and it stresses the well-established rule that allowances are subject to the approval of the reorganization judge. Both the Reorganization Judge and the Court below had before them an application for allowances by persons who not only did not contribute to the Plan of Reorganization of the Debtor, but whose sole interest in the estate was hostile, and who had been found by both the Trial Court and the Reorganization Judge to be wrongdoers with respect to the Debtor. Under the circumstances, there was no other course for the Reorganization Judge to pursue under the provisions of the Bankruptcy Act but to hold that these Petitioners are not entitled to compensation from the estate of the Debtor.

The decision of the Court below affirming the judgment of the Reorganization Judge is entirely consistent and in accord with the decisions of this Court.

Not only does the Bankruptcy Act specify in particular sections who may be entitled to compensation in a reorganization proceeding (§§ 221(4), 241(3), 242 and 243 of Chapter X (11 U. S. C. A., §§ 621(4), 641(3), 642 and 643)), but the reorganization judge must, under § 221(4) of the Bankruptcy Act, in approving any plan, be satisfied that "all payments made or promised by the debtor * * * for services and for costs and expenses" are reasonable and subject to the approval of the judge. Obviously, this statutory scheme is meaningless if, in fixing fees, the reorganization judge is required to apply a state statute. It would mean that the judgment and discretion of the reorganization judge is gone. It would mean that the standards prescribed by this Court in a whole series of cases for the reorganization judge are no longer those of this Court but those of any of the forty-eight states. This Court has consistently held otherwise. *Dickinson Co.* v. *Cowan,* 309 U. S. 382 (1940); *Woods* v. *City National Bank Co.,* 312 U. S. 262 (1941).

The fact that the Trustees' action was brought in the United States District Court for the Southern District of New York does not affect the right and power of the Reorganization Judge to determine allowances by Chapter X standards. It should be borne in mind, in the first place, that the action of the Trustees in the federal court was based not on diversity of citizenship but on the bankruptcy statute. In that respect, the action of the Trustees was entirely different from *Cohen, Executrix, et al.* v. *Beneficial Industrial Loan Corp.,* 337 U. S. 541 (1949), where the jurisdiction of the federal court rested on diversity of citizenship and the federal court was, therefore, sitting as an alter ego of the state court. And what is more important,

Cohen v. *Beneficial Loan Corp., supra,* did not involve the payment of fees out of an estate in Chapter X proceedings.

Nor is the argument of petitioners that state-created rights were sought to be enforced by the Trustees in the plenary action against Fogarty and Freeman of any consequence in a consideration of the question whether Fogarty and Freeman or their assignees are entitled to compensation from the estate of the Debtor under the Bankruptcy Law. Petitioners overlook entirely the difference, on the one hand, between the character of the right of the Trustees of the Debtor to compel an accounting by delinquent directors of the Debtor, and the right, on the other hand, of assignees of these delinquent directors to be paid fees by the Reorganization Court. These latter rights are not only completely different from but totally separate and independent of the former rights. That being so, the Reorganization Judge, in line with well-established principles of this Court, finding that these delinquent directors or their assignees had made no contribution to the Plan of Reorganization, that their position was hostile to that of the Debtor, and that these directors were found to be derelict in their duties to the Debtor but had escaped liability solely by virtue of the running of the statute of limitations, could not do anything except exercise a sound and wise discretion in denying the application for allowances.

For the purposes of this application, we do not have to discuss *National Mutual Insurance Co.* v. *Tidewater Transfer Co., Inc.,* 337 U. S. 582 (1949), dealt with at great length in Point II of Petitioners' brief. Nor do we have to argue the question urged by Petitioners that the right of the Trustees against delinquent directors of the Debtor rests on state law, because that is not germane to the question presented on this application. The fact is that whatever the character of the right of the Trustees against the delinquent directors may be—whether federal or state—the right of the

delinquent directors or their assignees to allowances in the reorganization court is clearly a matter of Chapter X law. The right to these allowances is a question separate and apart from the right of the Trustees against the delinquent directors. The two questions have no connection.

In Point II of their argument, Petitioners state that the Court below erroneously held that the New York statute was not applicable to the plenary action in the District Court, citing *Fielding* v. *Allen,* 181 F. 2d 163 (2d Cir., 1950). Petitioners suggest that this is in conflict with the statements of this Court in *National Ins. Co.* v. *Tidewater Co., supra.* A reading of the opinion of the Court below makes it clear that its reference to *Fielding* v. *Allen, supra,* was not with respect to the question raised in *National Ins. Co.* v. *Tidewater Co., supra.* The Court below was referring to the argument of Petitioners below that, on an application for compensation of this character, state law controls, under the authority of *Cohen* v. *Beneficial Loan Corp., supra.* The Court below pointed out that *Cohen* v. *Beneficial Loan Corp.* was a case involving jurisdiction based on diversity of citizenship, and that that was the reason why the New Jersey law was applied. The Court below referred to *Fielding* v. *Allen, supra,* not as a ground for decision in this case, but as an example of a type of case where the decision of *Cohen* v. *Beneficial Loan Corp., supra,* will not apply, i.e., a case where an action in the federal court is not governed by state rules. However, the ground of the decision of the Court below was not *Fielding* v. *Allen, supra,* or a doctrine that the action brought by the Trustees rested on federal rights, but that the application for compensation was something separate and apart from the action of the Trustees, was a bankruptcy matter, and as such must be governed only by that law.

There is no conflict between the decision of the Court below and the decision of the Court of Appeals for the

Seventh Circuit in *In re Granada Apartments, Inc.*, 155 F. 2d 882 (1946), cert. den. 329 U. S. 785 (1946). In one respect, the decisions reached by both Courts of Appeal were identical in that in each case the disposition of the reorganization judge of a claim for legal fees was affirmed by the Court of Appeals as a proper exercise of the broad judicial discretion vested in him by Chapter X.*

In *Granada,* the petitioner was an indenture trustee which, after managing the property, turned it over to the reorganization trustee. The indenture trustee filed a claim for services rendered in the reorganization proceeding. The Chapter X trustee opposed the claim on the ground that the indenture trustee had represented conflicting interests and, in a counterclaim, asserted charges of maladministration on the part of the indenture trustee. These claims and counterclaims were tried by the reorganization judge in a plenary proceeding. The District Court ultimately awarded the indenture trustee its fees and expenses incurred in defending itself with respect to the administration of the estate in its possession.

Several facts must be noted about the *Granada* case. In the first place, the indenture trustee had a right to request compensation under § 242(1) of the Bankruptcy Act (11 U. S. C. A. § 642(1)). In the second place, the indenture trustee was acquitted of any charge of misconduct. In the third place, the indenture trustee had a lien on the assets turned over to the Chapter X trustee for compensation for services rendered in connection with those assets. This was a lien well established under equity law and perfected before the indenture trustee turned over the assets to the Chapter X trustee. The indenture trustee was appealing to the reorganization judge as a matter of equity, which was entirely consistent with the principles of Bank-

*In *Granada,* the Reorganization Judge was actually reversed because he erroneously computed the amount of the fee.

ruptcy Law. *Vanston Committee* v. *Green, supra.* On the other hand, in the instant case, neither Petitioners nor their assignors were parties to the reorganization proceeding; they did not have any connection with the Plan of Reorganization; they did not render any services except in litigating against the Trustees; and finally, they were held guilty of misconduct not only by the Trial Court but by the Reorganization Judge.

The two cases are entirely different and there is not the slightest conflict between the two decisions.

II.

THE PETITION FOR CERTIORARI SHOULD BE DENIED.

Respectfully submitted,

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MELVIN KRAFT,
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v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION[1]

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 38-54)[2] is reported at 240 F. 2d 546. The opinion of the Dis-

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[1] The Securities and Exchange Commission is a party to the reorganization in the District Court pursuant to Section 208 of the Bankruptcy Act (52 Stat. 894) and participated as an appellee in the Court of Appeals.

[2] "Pet. . . . ." refers to pages of the petition or the appendix attached thereto.

trict Court is not reported. It is set forth in the appendix, *infra,* at pp. 12-16.

JURISDICTION

The judgment of the Court of Appeals (Pet. 2) was entered on January 7, 1957. The petition for a writ of certiorari was filed on April 8, 1957. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the reorganization court in a proceeding under Chapter X of the Bankruptcy Act must apply a state indemnification statute, which requires payment by a corporation of reasonable legal fees and expenses incurred by its officers and directors who have successfully defended an action brought against them, when former corporate officials of the debtor have escaped liability for mismanagement in an action brought by the reorganization trustee by reason of the running of the statute of limitations of the jurisdiction where service could be effected upon them.

STATUTES INVOLVED

Chapter X of the Bankruptcy Act, 52 Stat. 883, *et seq.,* and particularly Sections 167(3), 221(4), 241, 242 and 243, are involved in this proceeding, as well as Article 6-A of the New York General Corporation Law, N. Y. Sess. Law 1945, c. 869 § 4. These statutes are included in the appendix to the petition (Pet. 30-37), except Section 167(3) of the Bankruptcy Act, which is set out in the appendix hereto, *infra,* p. 12.

STATEMENT

The trustees of Central States Electric Corporation, which has been in reorganization in the United States District Court for the Eastern District of Virginia under Chapter X of the Bankruptcy Act, brought an action in the United States District Court for the Southern District of New York against the debtor's controlling stockholder and others, including James F. Fogarty and Herbert C. Freeman, the assignors of the petitioners herein.[3] The action, based essentially upon acts of mismanagement, was dismissed as to Fogarty and Freeman, although it was found that while officials of the debtor they had acted contrary to its interests and the dismissal as to several of the counts was solely by reason of the running of the statute of limitations. See *Austrian* v. *Williams,* 103 F. Supp. 64, 92, 96-97, 101 (S.D. N.Y.), reversed, 198 F. 2d 697 (C.A. 2), certiorari denied, 344 U.S. 909.

Fogarty, Freeman, and other defendants in the trustees' action in the United States District Court for the Southern District of New York filed applications in that court after the action had terminated seeking the determination and assessment against the debtor of their reasonable expenses and attorneys' fees pursuant to Article 6-A of the General Corporation Law of New York. With respect to Fogarty and Freeman the court assessed attorneys' fees at $30,000 and disbursements at $1,185.53, believing that the decision of the Court of Appeals for the Second Circuit in *Austrian*

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[3] That matter was before this Court in *Williams* v. *Austrian,* 331 U.S. 642.

v. *Williams*, 198 F. 2d 697 (C.A. 2), with respect to the application of the New York statute of limitations, required a similar holding with respect to Article 6-A of the New York General Corporation Law.[4] On appeal, the Court of Appeals for the Second Circuit held that this was "a mistaken view" of its decision; it did not decide, however, the question whether Article 6-A should be applied, holding that the determination of such a question "was a function belonging exclusively to the Virginia Reorganization Court."[5]

Thereafter, the claims of Fogarty and Freeman for legal services and disbursements were assigned to petitioners, the attorneys who performed the services. They filed a petition in the reorganization court seeking an allowance from the debtor's estate upon the ground that the reorganization court was required by Article 6-A of the New York General Corporation Law to award allowances to petitioners, as assignees of the successful defendants in the action brought in the federal District Court in New York, or, alternatively, that petitioners' services in defending against the trustees' action were compensable as administration expenses of the debtor's estate. The reorganization court dismissed the petition, holding that neither alternative justified an award of fees to the petitioners out of the Chapter X estate, and the court below affirmed both holdings. Petitioners seek review here of the determination that the New York statutory provision is not controlling, but do not seek review in this Court of their alternative contention (Pet. 17).

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[4] *Austrian* v. *Williams*, 120 F. Supp. 900, 903-904 (S.D. N.Y.).

[5] *Austrian* v. *Williams*, 216 F. 2d 278, 281 (C.A. 2), certiorari denied *sub nom. Fogarty* v. *Austrian*, 348 U.S. 953.

ARGUMENT

The determination of both courts below that the New York statutory provision for indemnification of corporate officials should not be applicable to the debtor in proceedings under Chapter X of the Bankruptcy Act is clearly correct, does not conflict with the result reached by any other court, and requires no review by this Court. Other questions sought to be raised by the petition (Pet. 3) are not presented in the instant case.

1. Sections 241, 242 and 243 of Article XIII set forth the services which are compensable from the Chapter X estate. Under these sections services are compensable only if they result in a benefit to the estate.[6] As stated in *Dickinson Industrial Site, Inc.* v. *Cowan*, 309 U.S. 382, 389:

> Fee claimants are either officers of the court or fiduciaries, such as members of committees, whose claims for allowance from the estate are based only on service rendered to and benefits received by the estate. [Footnotes omitted.]

The court below found that petitioners' services were not compensable under these sections (Pet. 49-52) and petitioners specifically state that they do not seek review of that determination (Pet. 17).

But unless awards for the services involved are authorized by the foregoing sections, they may not be paid. The court below implicitly, (Pet. 50-51) and the Court of Appeals for the Second Circuit[7] explicitly, have held that the claims for legal expenses here involved are "for services and for costs and expenses"

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[6] See 6 Collier on *Bankruptcy*, 14th ed. (1947) ¶ 13.02.

[7] *Austrian* v. *Williams*, 216 F. 2d 278, 283-284 (C.A. 2).

within the meaning of Section 221(4) of the Bankruptcy Act, which section provides that the reorganization court must pass upon the reasonableness of all payments therefor. And *Brown* v. *Gerdes,* 321 U.S. 178, 182, makes clear that the "detailed machinery" of Chapter X governs all claims under Section 221(4) for allowances from the estate.

Brown v. *Gerdes, supra,* held that Section 475 of the New York Judiciary Law, providing for the creation and enforcement of an attorney's lien on the recovery of a lawsuit, was not applicable to an action brought by a Chapter X trustee in the New York State courts. In stating that Chapter X contained the exclusive provisions for payments of legal fees out of the estate, this Court referred to "the establishment of more effective control over reorganization fees and expenses . . . in recognition of the effect which a depletion of the cash resources of the estate may have on both the fairness and feasibility of the plan of reorganization" (321 U.S. at 181). It also referred to "the purpose of the Act to protect the security holders against previous acts of mismanagement and to preserve all assets of the estate," noting that Section 216 (13) specifically provides "for retention and enforcement by the trustee of all claims of the debtor or the estate not settled or adjusted in the plan" (*id.* at 182).

These considerations are equally applicable here. As noted by the court below, application of the New York statute here involved would be contrary to the aim of Congress "to reasonably minimize the expenses of administration" (Pet. 48).[8] The court also re-

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[8] *Cf. Callaghan* v. *Reconstruction Finance Corporation,* 297 U.S. 464, 469.

ferred to Section 167 of the Bankruptcy Act which requires the independent trustee to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate." As this Court noted in *Williams* v. *Austrian,* 331 U.S. 642, 657, the Senate Committee report on the Chandler Act stated that this provision "insured the 'prosecution of all causes of action.' "

Prosecution of such actions against former officials, which have resulted in substantial recoveries for debtors in reorganization, will not be "insured" if a state may impose upon the debtor's estate substantial expenses in the event the action should ultimately prove unsuccessful. Indeed, in the instant reorganization proceeding, the possibility of loss to security holders by the amount of the trustee's litigation expenses in the event the action should be unsuccessful deterred the original trustees from recommending the institution of actions against the former officials of the company. *Committee for Holders, etc.* v. *Kent,* 143 F. 2d 684, 685 (C.A. 4). Although the action was ultimately unsuccessful, the district judge had awarded a judgment in excess of $14,000,000 with interest from 1929 on behalf of the estate against two of the defendants thereto, and the appellate court was not unanimous in reversing that judgment.

Accordingly, the state statute here involved was properly held inapplicable to the extent that it would permit claims "for services and for costs and expenses" within the meaning of Section 221(4) to be paid from the estate contrary to the provisions of Article XIII of the Bankruptcy Act, which this Court held in *Brown* v. *Gerdes, supra,* to be exclusive, and

contrary to important purposes of Chapter X, which that case held must prevail over provisions of state law.

Stellwagen v. *Clum,* 245 U.S. 605, 614-615, from which petitioners quote at length (Pet. 14-15), held that the state statute there involved, which was "intended . . . to promote the equal distribution of insolvent estates," was "not opposed to the policy of the bankruptcy law." The Court noted: "It is only state laws which conflict with the bankruptcy laws of Congress that are suspended; those which are in aid of the Bankruptcy Act can stand." This is wholly consistent with the opinion of the court below, which noted that it is "contrary to the manifest policy of Chapter 10 to subject and hamper its provisions by a State statute which would authorize awarding fees and expenses to defendants sued for recovery of assets of the corporation whether the suits are successful or not." (Pet. 48).

Cohen v. *Beneficial Loan Corp.,* 337 U.S. 541, relied on by the petitioners (Pet. 13), had no connection with the Bankruptcy Act and there was no conflict in that case with the provisions of any federal law.

Harrigan v. *Bergdoll,* 270 U.S. 560, and *Austrian* v. *Williams,* 198 F. 2d 697 (C.A. 2), cited by petitioners (Pet. 16), held that a state statute of limitations applies to an action brought by a bankruptcy trustee, but, as noted in the latter case, there is a specific provision in the Bankruptcy Act under which a state statute of limitations applies.[9] With reference to the language quoted from the *Harrigan* case, we do not

[9] See *Austrian* v. *Williams,* 198 F. 2d 697, 699 (C.A. 2), where Section 11(e) of the Bankruptcy Act is quoted. And see *Austrian* v. *Williams,* 216 F. 2d 278, 281 (C.A. 2).

suggest that the trustees' cause of action is different from that which the corporation itself might have enforced. We urge only that the indemnity provision is not an integral condition to the enforcement of the cause of action brought by the trustees, which was based upon general equitable principles,[10] and, being in conflict with the policies of the Bankruptcy Act, it may not be held applicable.

In re Granada Apartments, 155 F. 2d 882 (C.A. 7), certiorari denied, 329 U.S. 785, also relied upon in the petition (Pet. 24-27), was expressly distinguished by the court below. In that case there was reliance not on a state statute passed to indemnify directors, but, as the court below noted, upon a specific "contractual right to deduct from the property or funds" in the possession of the indenture trustee its reasonable expenses for successfully defending itself with respect to its duties, and upon the equitable principle "that a trustee in possession is entitled to be allowed from the fund in his possession expenses incurred in defending the trust committed to its charge, including reasonable compensation for services and expenses" (Pet. 53-54). There is no equitable principle that requires payment of compensation to former directors of the debtor corporation in accordance with a state indemnification statute (passed long after the directors

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[10] Even assuming arguendo (but see pp. 10-11, *infra*) that the trustees' cause of action had been based on the New York General Corporation Law (see Article 6, quoted at Pet. 29-30), it would not necessarily follow that application of the indemnity provisions was a necessary concomitant thereto. Cf. *Brown* v. *Gerdes,* 321 U.S. 178, 186: "The fact that New York has adopted measures designed to protect attorneys practicing in its courts does not demonstrate that New York has made its control over the fees a condition to the use of its tribunals."

had resigned) where they required the debtor's trustees to sue them in a jurisdiction other than where the debtor's affairs were being administered so that they might seek the shelter of a favorable statute of limitations. The petition points out (Pet. 11) that the policy of the indemnification statute "is to induce capable men to assume corporate directorships and overcome the fear of having to defend groundless actions at their own expense". As noted by the court below, "suits not based on probable cause should not be authorized by the Reorganization Judge and cannot be instituted without his order of approval" (Pet. 48).

2. The first two questions set forth in the petition (Pet. 3) are bottomed upon the assumption that the court below held that the Chapter X trustees' causes of action against the petitioners' assignors were based on "federal substantive law" or on "federal doctrines of general equity jurisprudence" (Pet. 3). These holdings are alleged to conflict with *Williams* v. *Austrian*, 331 U.S. 642 (Pet. 23). As the foregoing discussion makes clear, no such holding was necessary to the ultimate determination of the court below, and we submit that the court's opinion, read in its entirety, merely points out that the "substantive right of action" that the trustees sought to enforce in the United States District Court in New York was not created by the New York statute pursuant to which petitioners seek legal fees out of the estate, but was based on general equitable principles which would have been applicable wherever the action had been brought. To the extent that the New York statute authorizes an action against directors and officers of a corporation to compel them to account for official mis-

conduct, as the Court of Appeals noted, it "is merely a reflection but not a creation of the substantive equitable rights contained in equity jurisprudence" (Pet. 45). Hence, the court's opinion is not inconsistent with the quotation in the petition (Pet. 20) from *Williams* v. *Austrian*, 331 U.S. 642, 667, that the cause of action was "essentially State litigation." "State litigation" does not exclude causes of action which are transitory in nature—the characterization of the trustees' cause of action in *Committee for Holders, etc.* v. *Kent*, 143 F. 2d 684, 687 (C.A. 4). And see *Austrian* v. *Williams*, 198 F. 2d 697, 699-700 (C.A. 2), where the Court of Appeals for the Second Circuit, in applying the New York statute of limitations to the trustees' action, indicated its view that "the causes of action may have arisen under Virginia law."

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1957.

APPENDIX

Section 167 of the Bankruptcy Act (52 Stat. 890) provides in pertinent part:

"The trustee upon his appointment and qualification—

> "(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;
>
> "(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;
>
> "(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;
>
> * * *

Opinion of the United States District Court for the Eastern District of Virginia

No. 16-620

In the Matter

of

CENTRAL STATES ELECTRIC CORPORATION,
a Corporation, *Debtor.*

In 1942 Central States Electric Corporation filed a petition in this Court for reorganization under Chapter X of the Bankruptcy Act. At that time the debtor had outstanding a large amount of debentures and preferred stocks. The market value of the assets, which consisted entirely of securities, reached a high of

approximately $400,000,000.00 in 1929. At the time the petition was filed the value of its assets was approximately $1,300,000.00. The trustees originally appointed conducted an investigation which indicated a probable liability on the part of certain officers, directors and stockholders of the corporation for mismanagement, but recommended against the institution of suits. The recommendation was based principally upon the ground that recovery was barred by the statute of limitations. Furthermore, the assets in the hands of the trustees were insufficient to pay the secured creditors who opposed the expenditure of assets in the prosecution of such actions which they believed would be barren of results. The District Court approved the recommendation of the trustees and a committee of preferred stockholders appealed. *Committee* v. *Kent,* 143 Fed. (2d), 684. The Court of Appeals reversed the District Court and directed a further investigation with the view of instituting suit against certain members of the former management. Thereafter the original trustees resigned and additional trustees were appointed. In conformity with the directions of the Court of Appeals, Fourth District, a further investigation was conducted and the new trustees recommended that suit be brought. The District Court thereupon entered an order authorizing the institution of such action. The suit was brought in the District Court for the Southern District of New York and a protracted and complicated proceeding developed. The District Court dismissed the complaint for lack of jurisdiction. *Austrian* v. *Williams,* 67 Fed. Supp. 223. The Court of Appeals, Second Circuit, reversed and remanded the case. 159 Fed. (2d) 67. The Supreme Court granted certiorari and affirmed the decision of the Court of Appeals, 330 U. S. 813, and 331 U. S. 642. The action thereupon came to trial on the merits and after a lengthy trial an opinion was filed setting forth detailed findings of fact. *Austrian* v. *Williams,* 103 Fed. Supp. 64.

Among the defendants were James F. Fogarty and Herbert C. Freeman, who were among the group in control of the affairs of the corporation prior to the filing of the petition. In the New York proceeding the action against these defendants, Messrs. Fogarty and Freeman, was dismissed solely by reason of the bar of the statute of limitations, although the Court found that they failed to exercise due care or prudence in the discharge of liability and acted contrary to the interests of the corporation. 103 Fed. Supp., at 92. Judgment in excess of $15,000,000.00 was entered against the other defendants, which judgment was reversed by the Court of Appeals, Second Circuit. *Austrian* v. *Williams,* 198 Fed. (2d) 697; certiorari denied 344 U. S. 909. While the New York litigation was pending various reorganization plans were submitted to this Court and in 1950 a plan was submitted by the trustees which was approved. During the interval since the petition was filed the market value of the assets had increased to approximately $38,000,000.00, exclusive of the claims against the defendants in the New York litigation. In re: *Central States Electric Corporation,* 112 Fed. Supp. 281. See also *Central States* v. *Austrian,* 183 Fed. (2d), 879, and *Chase* v. *Austrian,* 189 Fed. (2d), 555. Since the consummation of the plan a number of cash distributions have been made to senior preferred stockholders but not enough to satisfy the claims in full and there are junior preferred stockholders with claims aggregating more than $30,000,000.00. Common stockholders will receive nothing. After the termination of the New York proceeding Messrs. Fogarty and Freeman filed application in the Federal Court in New York pursuant to Article 6-A of the General Corporation Law of New York, seeking a determination and assessment against the debtor for reasonable expenses and attorneys' fees incurred in defense of the action. The New York Court entered an order assessing against the debtor in favor of Fogarty and Freeman certain ex-

penses and attorneys fees. The trustees appealed from that order and the Court of Appeals, Second Circuit, reversed and directed a dismissal in the District Court. *Austrian* v. *Williams,* 216 Fed. (2d), 278. The basis of the reversal was that jurisdiction concerning such allowances was in this Court as the reorganization court, but the Court specifically stated that the propriety of making the allowance was not passed upon.

Thereafter, petitioners in this proceeding, LeBoeuf, Lamb and Leiby, a firm of practicing attorneys in New York who represented Fogarty and Freeman in the New York litigation, applied to this Court for permission to accept an assignment of the claim asserted by Fogarty and Freeman in that proceeding. The basis of the application was *Section 249 of the Bankruptcy Act.* By an order dated December 7, 1955 the application was dismissed on the ground that the rights sought to be transferred or assigned were not claims against or stock of the debtor in the contemplation of the Act. Thereupon petitioners accepted the assignment and filed a petition in this Court seeking compensation.

Counsel have presented exhaustive briefs upon the question for determination and the case has been ably argued orally. My conclusions can be briefly stated.

With respect to the application of *Article 6-A of the New York General Corporation Law,* it is to be borne in mind that this is a Chapter X proceeding. The proceeding in the District Court in New York was incident to the reorganization proceeding in this District and the Court there acquired jurisdiction under the Bankruptcy Act. *Williams* v. *Austrian,* 331 U. S. 647. In view of this it is my opinion that the New York law is not binding upon the reorganization court. Upon the contrary, the rights of petitioners are to be determined in accordance with the principles applicable in Federal Courts without reference to the state law. Petitioners contend alternatively that if they are not entitled to compensation

under the New York law they are entitled to an allowance under *Chapter X of the Bankruptcy Act.* As I understand the provisions of the Act in this respect, as a prerequisite to an award by the reorganization court it must be shown that services so compensated have resulted in benefit to the estate. The facts here are that the petitioners were acting exclusively for the protection of their clients, Fogarty and Freeman. To contend that their services in defending the New York litigation advanced or benefited the reorganization proceeding is unsound reasoning. While it is true the termination of that proceeding was necessary for a final disposition of the reorganization proceeding, I am unable to agree with the contention that counsel for the defendants, seeking to avoid liability for certain claims asserted by the trustees, contributed anything to the reorganization. While due recognition is given to the equitable principles upon which the New York law regarding compensation is based and to the fact that Messrs. Fogarty and Freeman were not held liable for mismanagement of the affairs of the corporation, it is to be borne in mind that the plea of the statute of limitations is the only successful defense which was interposed.

It is my conclusion that the General Corporation Law of New York is not binding upon this Court and that the services performed by the petitioners are not compensable in this reorganization proceeding.

Therefore the petition will be dismissed.

/Sgd./ STERLING HUTCHESON
United States District Judge

June 8, 1956

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LeBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby,

Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITIONERS' REPLY BRIEF

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Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITIONERS' REPLY BRIEF

Respondent trustee's brief would have the question presented on this petition for certiorari converted into a question of judicial *discretion* of the district judge in the bankruptcy reorganization court in the fixing of an allowance in accordance with the equity powers of a bankruptcy court. That, we submit, is erroneous.

The petition presents the important and unsettled question whether the provisions of the Bankruptcy Act conflict with a state statute which creates a liability for defendants' litigation expenses incurred in the successful

defense of an action brought by the bankruptcy trustees. The decision below was upon the ground that there is such a conflict which precludes the bankruptcy reorganization court from giving effect to such state-created liability.

Admittedly, when the reorganization court has given effect to the state-created liability, then that liability is subject to the equity powers of a bankruptcy court in the same manner and on the same terms that govern the administration in bankruptcy of all liabilities of a debtor. However, that was not, and on the facts, could not have been the basis of the decision below.

The respondent's brief argues (1) that the trial court found that petitioners' assignors "failed to exercise due care and prudence" and that the trustees' action was defeated "on the ground of statute of limitations" (brief, pp. 2 and 3), and (2) that the trial court in New York acted under an "erroneous impression" in interpreting the New York statute (brief, p. 4).

We shall reply to each of these points briefly herein.

POINT I

Respondent's answering brief (page 2) erroneously states that the trustees' action was defeated "on the ground of statute of limitations". The trustee further characterizes the rights of petitioners' assignors as those of "delinquent directors" (brief, pp. 2, 3, 12). The truth is that in the New York action the trustees failed to prove any delinquency and the action resulted in a judgment dismissing the complaint on the merits. The pertinent provisions of the final judgment entered in the New York action in relation to 3 transactions (of 13 alleged

in the complaint) to which the defense of the statute of limitations was considered read as follows:

> "8. In so far as concerns the 'C' and 'I' transactions of the complaint, recovery thereon against defendant Herbert C. Freeman, is barred by the statute of limitations, and the complaint thereon is accordingly dismissed on the merits against said defendant, and except as so adjudged the complaint against defendant, Herbert C. Freeman, be and hereby is dismissed on the merits.
>
> "9. In so far as concerns the 'C', 'I' and 'L' transactions of the complaint, recovery thereon against defendant, James F. Fogarty, is barred by the statute of limitations, and the complaint thereon is accordingly dismissed on the merits against said defendant; and except as so adjudged the complaint against defendant, James F. Fogarty, be and hereby is dismissed on the merits."

Without so stating, but as an attempt to go behind the final judgment, respondent's brief refers to the "C", "I" and "L" claims in which the trial court made tentative findings of liability on the part of petitioners' assignors. But respondent fails to mention that each such finding was made "subject, however, to a consideration of the defense of statute of limitations" (*Austrian, et al., Trustees* v. *Williams, et al.,* 103 F. Supp. 64, at pp. 92, 97 and 101). On consideration of the New York statute of limitations all of the 3 claims were held barred (103 F. Supp. 64, at p. 117).

The decisions of this and other courts hold that statutes of limitations not only require a finding in favor of a defendant who validly raises the defense of such statute, but the statutes also create an irrebuttable factual presumption in favor of such defendants. For example, as

this Court said in *United States* v. *Oregon Lumber Co.*, 260 U. S. 290, at p. 299:

> "Such statutes [of limitations] * * * supply the place of evidence lost or impaired by lapse of time by raising a presumption which renders proof unnecessary. * * *"

The practice of imputing guilt to a defendant claiming constitutional and statutory privileges designed to protect the innocent has been deplored by this Court. In *Ullmann* v. *United States*, 350 U. S. 422, this Court said (at p. 426):

> "* * * This constitutional protection [against incrimination] must not be interpreted in a hostile or niggardly spirit. Too many, even those who should be better advised, view this privilege as a shelter for wrongdoers. They too readily assume that those who invoke it are either guilty of crime or commit perjury in claiming the privilege. * * *"

In a subsequent case, *Slochower* v. *Board of Education*, 350 U. S. 551, this Court held that the claim of privilege should not be used collaterally as a basis to deprive a person of public employment. There, in a discussion which is equally appropriate to the defense of the statute of limitations, the Court said (at pp. 557-558):

> "* * * The privilege against self-incrimination would be reduced to a hollow mockery if its exercise could be taken as equivalent either to a confession of guilt or a conclusive presumption of perjury. As we pointed out in *Ullmann*, a witness may have a reasonable fear of prosecution and yet be innocent of any wrongdoing. The privilege serves to protect the innocent who otherwise might be ensnared by ambiguous circumstances. * * *"

When it is remembered that the claims asserted against petitioners' assignors involved transactions occurring more than 20 years prior to the date of the commencement of the trustees' action in New York with the resulting disability imposed on such assignors in bringing forward proof of the true circumstances, we submit that the assertion of the defense of the statute of limitations was to protect the assignors from the risk of being "ensnared by ambiguous circumstances". The fact that the defense was raised surely cannot be the basis of an inference of misconduct, and it was not so held by the New York trial court which entered the final judgment in favor of petitioners' assignors on the merits and from which the trustees took no appeal.

More important, a reference to the trial court's findings, when stated with the completeness which accuracy requires, which resulted in the final judgment of dismissal on the merits, cannot validly be the basis of an inference of adjudication of liability, which is the opposite of the adjudication as actually entered.

Furthermore, the assertion of the defense of the statute of limitations may not properly constitute a basis of depriving petitioners' assignors of any right available to them by statute under the guise of a so-called exercise of "judicial discretion". This, we submit, would reduce the benefits of statutes of limitations, which have been founded upon centuries of experience in developing a system of justice, to something dishonorable and "a hollow mockery", whereas the contrary is the true purpose of the law.

For the same reasons stated above, the clause on page 14 of respondent's brief that petitioners' assignors "were held guilty of misconduct not only by the Trial Court but by the Reorganization Judge" is false and prejudicial.

As we have shown above, the trial court's judgment of dismissal provides a complete negation and demonstrates the inaccuracy of such statement. Moreover, the reorganization court received no evidence of any misconduct by petitioners' assignors, and thus was not competent to adjudge the assignors *in absentia*.

POINT II

The brief of the respondent trustee criticizes the New York trial court by saying that it acted "under the erroneous impression that it was absolutely constrained by the New York statute to grant" the order which it entered assessing the litigation expenses of petitioners' assignors (brief, p. 4). That is amplified in a footnote at pages 4 and 5 in which reference is made to *Austrian, et al.* v. *Williams, et al.*, 216 F. 2d 278 and *Diamond* v. *Diamond*, 307 N. Y. 263.

The decision in *Austrian* v. *Williams, supra,* was an appeal by the reorganization trustees from the trial court's order granting petitioners' assignors their litigation expenses. The holding of the Second Circuit Court of Appeals was that only the reorganization court in Virginia had jurisdiction because that Court had exclusive jurisdiction over the property of the debtor corporation. As noted in our petition (p. 7), the reversal by the Second Circuit Court of Appeals was expressly stated to be without prejudice to renewal of the application in the reorganization court. But, more important, there was no discussion whatsoever regarding the question whether the New York statute creating the liability for such litigation expenses was discretionary or mandatory.

In *Diamond* v. *Diamond, supra,* both the plaintiff stockholder and the defendant director (and stockholder)

participated in a wrong to their corporation. For that reason a judgment of dismissal was entered. The question was whether the defendant had not been "adjudged" liable for negligence or misconduct within the meaning of Section 64 of the General Corporation Law of New York. A majority of the Court of Appeals held that the judgment of dismissal on the ground stated constituted an exception to the kind of adjudication intended by the statute. There the judgment was founded upon an estoppel against the plaintiff who had knowledge of and ratified and participated in the defendant's wrongful act. In the majority opinion by Desmond, J., it was said (at p. 267):

> "• • • if that word 'adjudged' must be limited in its application to the actual entry of a money judgment against the officer, director or employee, the exception is inapplicable. But 'adjudged' is not so completely a word of art or of such technical meaning, see 2 Words and Phrases, Adjudge, p. 411 et seq. that we cannot seek out the obvious legislative intent. Section 64, changing the common-law rule that each party pays his own lawyer, is to be construed strictly. See, Schwarz *v.* General Aniline & Film Corp. 305 N. Y. 395, 405, 113 N. E. 2d 533, 537. Rewarding faithless officers and directors was no part of its purpose. In all reason and common sense, this defendant has been, in the affirmed findings below, 'adjudged • • • liable for • • • misconduct in the performance of his [her] duties'. • • •"

Referring to the basis for such an interpretation of the word "adjudged", the opinion further stated (at pp. 266, 267):

> "• • • The rule is that, when stockholders are individually estopped from questioning wrongs done

> their corporation, they cannot redress those same wrongs through a suit brought directly by the corporation or derivatively, by themselves, for the corporation. So it was rightly held [in the Court below] here that this plaintiff, estopped by knowledge, ratification and participation, could not, by way of a stockholder's suit, have judgment against her coconspirator, for those wrongs.
>
> "All this should, it seems, be ample warrant for denying to both, or either of these stockholders, payment, out of the corporate till, of their court expenses. * * *"

The *Diamond* case, therefore, presented an unusual and special circumstance which is completely distinguishable from the trustees' New York action. The judgment in favor of the petitioners' assignors was not founded upon estoppel. It resulted from plaintiff trustees' failure of proof or abandonment in respect of 10 of the 13 claims alleged and as to 3 claims the tentative findings of liability were made expressly subject to a consideration of the statute of limitations. On consideration of the presumptions thereby raised, as we have noted, as well as the failure of proof, petitioners' assignors were held entitled to a final judgment of dismissal on the merits.

Except in the estoppel situation in *Diamond* v. *Diamond*, the New York Courts have uniformly held in accord with the trial court in the New York action (*Austrian* v. *Williams*, 120 F. Supp. 900) that Section 64 is a mandatory statutory direction and confers no discretionary power. (See *Dornan* v. *Humphrey*, 278 App. Div. 1010; *Neuberger* v. *Barrett*, 180 Misc. 222, 39 N. Y. S. 2d 575).

The respondent's suggestion (brief, p. 13) that the rights created by the mandatory requirement of the state statute are subject, to a greater extent than other state-

created substantive rights, to the discretionary powers of the bankruptcy reorganization court is without merit. In the petition for certiorari (at pp. 10-18) it has been shown that such holding below was erroneous and that this substantive right created by state law is enforceable in reorganization proceedings in a federal bankruptcy court to the same extent as any other state-created substantive right.

Nothing in the Bankruptcy Act conflicts in any way with the enforcement of the liability against the debtor's estate in accordance with the New York statute. Here no grounds have been shown for the exercise of any discretion in either denying, limiting or otherwise restricting the enforcement of the state-created right to the litigation expenses here involved.

There is no showing that the debtor's estate does not have adequate funds with which to discharge such liability or that the allowance of the state-created right would otherwise be inequitable. The only argument advanced by the respondent trustee for the discretionary power of the bankruptcy court is the erroneous assertion that the final judgment in the trustees' action was solely the result of the defense of the statute of limitations. That assertion has been shown to be contrary to the true facts.

We repeat that neither the final judgment on the merits nor any tentative findings of the trial court create any imputation of wrongdoing on the part of petitioners' assignors which precludes the benefit of state statute in a bankruptcy court.

POINT III

The authorities on which respondent relies are distinguishable and have no application to the question presented herein.

The principal authority cited by respondent is *Vanston Committee* v. *Green,* 329 U. S. 156. There the question involved was the allowance of interest on interest in the distribution of a bankrupt's estate. It was found to be the policy of the bankruptcy law that the allowance of such interest on interest was inequitable during the period of the bankruptcy when payment was suspended by order of the bankruptcy court. As the concurring opinion of Justice Frankfurter shows, such was also the rule of the state law creating the claim in the first instance.

In *Pepper* v. *Litton,* 308 U. S. 295, the question involved the disallowance of a claim based on a judgment procured in a state court on the ground that the procuring of such judgment involved improper conduct and an attempt to defraud a creditor. The disallowance was clearly an exercise of proper equitable jurisdiction of the bankruptcy court.

Brown v. *Gerdes,* 321 U. S. 178, involved compensation for an attorney who had furnished services to the trustee in bankruptcy. Both the state court and the reorganization court held that allowance of compensation of such attorney was exclusively a subject for the reorganization court, pursuant to whose order the attorney was employed.

Leiman v. *Guttman,* 336 U. S. 1, involved services rendered directly in the reorganization proceeding by an attorney for a committee of preferred stockholders. It was held that the bankruptcy court, not the state court, had exclusive jurisdiction to make an allowance payable

out of shares of preferred stock which the committee had placed in escrow for that purpose.

Callaghan v. *Reconstruction Finance Corporation*, 297 U. S. 464, involved the compensation of a court-appointed trustee in bankruptcy, and not the rights of persons who were strangers to the bankruptcy proceeding.

In respect of *Fielding* v. *Allen*, 181 F. 2d 163 (2d Cir. 1950) the respondent, following the same error of the Court below, fails to recognize that there were two separate causes of action: one founded upon state law in respect of which it was held that the state law requiring security for litigation expenses applied; the second, an alleged violation of the Interstate Commerce Act, was founded upon federal law as to which the state statute was not applicable. Here the trustees' action was founded upon state law.

There is likewise error on the part of the respondent in reading the decision of the Court of Appeals for the Seventh Circuit in *In re Granada Apartments, Inc.*, 155 F. 2d 882; cert. den. 329 U. S. 785. There the reorganization trustee brought a plenary action against a former trustee under a mortgage on the debtor's property for alleged mismanagement of the mortgaged property during the period of the mortgage trustee's administration thereof. The mortgage trustee successfully defended the plenary suit and the reorganization court allowed the litigation expenses in the successful defense of such suit.

In *Granada* there was no assertion of a right to compensation under Section 242(1) of the Bankruptcy Act (11 U.S.C.A. §642(1)). The claim against the debtor's estate for expenses incurred in the successful defense of the action brought by the reorganization trustee was founded upon and was upheld as a matter of Illinois substantive case law.

Although the mortgage trustee may have had a lien prior to the transfer of the mortgaged assets to the Chapter X trustee for his services in the management of the trust assets, the fact is that there was no lien at the time of the transfer of the property to the reorganization trustee. The claim of the mortgage trustee was not for management services, but was for legal expenses subsequently incurred in the successful defense of the suit by the Chapter X trustee. The decision was not based on the existence of a lien.

Finally, it is not true that the mortgage trustee was appealing to the reorganization judge either as a matter of "broad judicial discretion" or "as a matter of equity", as asserted in respondent's brief (p. 13). The fact is the mortgage trustee was defending, in a plenary action the reorganization trustee's charges of mismanagement of the mortgaged property. The claim in the suit of the reorganization trustee was founded upon substantive rights created by the law of Illinois, which were held to be without merit, and the subsequent claim of the mortgage trustee for reasonable litigation expenses in the successful defense of the reorganization trustee's plenary suit was also founded upon Illinois substantive law. The claim was not founded upon the provisions of the Bankruptcy Act.

The Court of Appeals for the Seventh Circuit, citing Illinois decisions, held that the mortgage trustee's expenses were enforceable in the reorganization proceedings and that nothing in Chapter X of the Bankruptcy Act was in conflict therewith.

It should also be noted that the mortgage trustee in defending the suit brought by the trustee in reorganization was not a party to the reorganization proceeding.

Petitioners' assignors were in precisely the same relation to the reorganization proceedings here. The mortgage trustee, as is the case of petitioners' assignors, was made a party to a plenary suit brought by a reorganization trustee alleging misfeasance in office during a period preceding the petition for reorganization in bankruptcy.

Thus, when correctly read, we respectfully submit, the *Granada* case is on all fours with the claim for litigation expenses asserted by petitioners' assignors under New York law.

There being no conflict between Chapter X of the Bankruptcy Act and the New York statute, the claim should be heard and determined by the reorganization court in accordance with New York law and payment directed out of the debtor's estate, which is under the jurisdiction of the reorganization court.

Conclusion

Respondent's brief has attempted to deal with the merits of petitioners' claim and in doing so it has not made any showing against petitioners' principal contention, namely, that the Court below has decided an important question of the relation between the Bankruptcy Act and the liability created under state law, which has not been but should be settled by this Court. Likewise, respondent has now shown the absence of any conflict between the decision below and the decision of the Seventh

Circuit Court of Appeals in *In re Granada Apartments, Inc. supra.*

We respectfully submit, therefore, that the petition for certiorari should be allowed.

Respectfully submitted,

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